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No. 76-624

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, *Petitioner*

v.

THE UNITED STATES, *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	i
TABLE OF AUTHORITIES	ii
OPINIONS BELOW	1
JURISDICTION	1
QUESTIONS PRESENTED	2
STATUTE INVOLVED	2
STATEMENT	3
SUMMARY OF ARGUMENT	12
ARGUMENT	
I. THE TRANSACTION SHOULD BE TAXED AS IT WAS STRUCTURED BY THE PARTIES—AS A BONA FIDE SALE AND LEASEBACK	15
II. THERE IS NO BASIS FOR DISALLOWING THE DEDUCTION OF INTEREST WHICH LYON PAID ON MONEY IT BORROWED	24
III. CONSIDERATIONS OF TAX "SUBSTANCE" SUPPORT LYON'S CLAIM TO THE DEDUCTION OF DEPRECIATION, INTEREST, AND EXPENSES	26
A. Under the Agreement, Lyon is the Party Most Likely to Sustain the Burden of Depreciation in the Value of the Building Through "Wear and Tear" or "Obsolesence"	26
1. Option Prices and Rentals	28
2. The 25-Year Breakpoint	30
B. The Spurious Nature of the Commissioner's Action Is Clearly Shown by the Inclusion in Lyon's Income of Imputed "Interest" From Worthen	34

Page

C. The Government's "Conduit" Theory of the Loan Payments to the New York Life Insurance Company Is Inconsistent With the Legal Obligations of the Parties, With a Practical Construction of the Effect of Those Obligations, and With This Court's Decision in Commissioner v. Brown 37

D. Commissioner v. First Security Bank of Utah, Precludes a Finding That Worthen Owns the Bank Building for Tax Purposes 44

IV. The Transaction Should Be Taxed In Accordance With The Detailed Factual Findings Of The District Court 46

Conclusion 55

TABLE OF AUTHORITIES

Cases: Page

American Realty Trust v. *United States*, 498 F.2d 1194 (4th Cir. 1974) 13, 14, 19, 49, 51-53
Arkansas Bank & Trust Co. v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963) 19
Benjamin Levinson, 45 T.C. 380 (1966) 22
Benton v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) 18-19
Breece Veneer & Panel Co. v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956) 19
Butler v. *Adler-Goldman Commission Company*, 62 Ark. 445, 35 S.W. 1110 (1896) 43
Carl L. Danielson, 50 T.C. 782 (1968) 22
Commissioner v. *Brown*, 380 U.S. 563 (1965) 13, 37-39
Commissioner v. *Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) 22
Commissioner v. *Duberstein*, 363 U.S. 278 (1960) ..49, 51, 53
Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 (1972) 14, 44-45
Cubic Corporation v. *United States*, 541 F.2d 829 (9th Cir. 1976) 19
First Agricultural National Bank v. *State Tax Commission*, 392 U.S. 339 (1968) 7

Page

Gregory v. *Helvering*, 293 U.S. 465 (1935) 15
Helvering v. *Lazarus & Co.*, 308 U.S. 252 (1939) 13,19, 27, 50-51
Horton v. *United States Steel Corp.*, 286 F.2d 710 (5th Cir. 1961) 53
Journal-Tribune Publishing Co. v. *Commissioner*, 348 F.2d 266 (8th Cir. 1965) 28
Kearney & Trecker Corp. v. *United States*, 195 F. Supp. 158 (E.D. Wisc. 1961) 19, 49
Knetsch v. *United States*, 364 U.S. 361 (1960) 16
Lockhart Leasing Co. v. *United States*, 446 F.2d 269 (10th Cir. 1971) 51
Lundgren v. *Freeman*, 307 F.2d 104 (9th Cir. 1962) ... 53
Meiselman v. *Commissioner*, 300 F.2d 666 (4th Cir. 1962) 19
National Carbide Corp. v. *Commissioner*, 336 U.S. 422 (1949) 25
Northwest Acceptance Corp., 58 T.C. 836 (1972) *aff'd* 500 F.2d 1222 (9th Cir. 1974) 30, 49, 50-51, 53
Oesterreich v. *Commissioner*, 226 F.2d 798 (9th Cir. 1955) 19
Reade Manufacturing Co., 32 T.C.M. 1225 (1973) 19, 50
Spring City Foundry Co. v. *Commissioner*, 292 U.S. 182 (1934) 35
Stirman v. *Cravens*, 33 Ark. 376 (1878) 42-43
Storthz v. *Sanger*, 108 Ark. 154, 156 S.W. 1020 (1913) . 43
United States v. *Anderson*, 269 U.S. 422 (1926) 35
United States v. *Singer Manufacturing Co.*, 374 U.S. 174 (1963) 53
United States v. *United States Gypsum Co.*, 333 U.S. 364 (1948) 53
Van Zandt v. *Commissioner*, 341 F.2d 440 (5th Cir. 1965) 17
Western Contracting Corp. v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959) 19
Williams v. *Kirby School District No. 32*, 207 Ark. 458, 181 S.W. 2d 488 (1944) 42
Witherspoon v. *Nickels*, 27 Ark. 332 (1871) 43
World Publishing Co. v. *Commissioner*, 299 F.2d 614 (8th Cir. 1962) 22-23

Page

STATUTES AND REGULATIONS:

Income Tax Regulations:

§ 1.167(a)-4 28
§ 1.446-1(c)(ii) 35
Int. Rev. Code, § 48(d) 27
Int. Rev. Code, § 163(a) 2, 24
Int. Rev. Code, § 167(a) 2, 27
Int. Rev. Code, § 178 28
Int. Rev. Code, § 482 45
Fed. R. Civ. P. 52(a) 50, 53

OTHER AUTHORITIES:

1966-2 Cum. Bull. 5 22
Lefevre, "The Tax Law of Lease Transactions Revisited" 53 *Taxes* 764 (1975) 20
9 Wright & Miller, Federal Practice & Procedure §§ 2587, 2589 (1971) 53

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 536 F.2d 246, and is reproduced in the appendix to the petition for certiorari as appendix B (Pet. App. pp. 15a-30a). The memorandum opinion, findings of fact and conclusions of law of the district court, as supplemented, are not reported; they are set forth as appendix A to the petition for certiorari (Pet. App. pp. 1a-14a).

JURISDICTION

The judgment below was entered on May 26, 1976 (Pet. App. C, p. 31a). On August 6, 1976, the court

of appeals denied a timely petition for rehearing (Pet. App. D, pp. 32a-33a). The petition for certiorari was filed November 3, 1976, and the petition was granted on February 22, 1977. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the petitioner was entitled, as owner-lessor of a building, to deduct on its Federal income tax returns depreciation with respect to that building, and interest and expenses which it paid in connection with loans on which it was liable.

2. Whether the court of appeals erred in setting aside the factual and legal judgment of the district court that the petitioner was entitled to the interest and depreciation deductions, on the basis of the court of appeals' own conclusion that the "cumulative effect" of otherwise ordinary lease features rendered the ownership interest of Lyon "too unsubstantial" to allow Lyon to claim depreciation and interest deductions.

STATUTE INVOLVED

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 167(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

STATEMENT

This case arises out of the sale and leaseback of a bank building between Frank Lyon Company ("Lyon") and Worthen Bank & Trust Company ("Worthen"), a bank located in Little Rock, Arkansas. The terms of that agreement were the result of arms-length bargaining between the parties and the overall structure of the arrangement was dictated by Federal and state banking regulations with which Worthen was bound to comply.

Worthen began to plan construction of a new multi-story bank and office building in 1965. (Finding 1, Pet. App. 3a; App. 125-126.) Initially Worthen planned to finance, build, and own the project itself at a total cost of $9,000,000 for the site, the building, and an adjoining parking facility. (Finding 2, Pet. App. 4a; App. 131.)

This initial plan was abandoned for two reasons:

(1) Worthen found itself unable to raise the necessary funds because of interest rate limitations imposed by state law; it had planned on a $5 million conventional mortgage and $4 million in debentures, but Arkansas law forbade Worthen (then a state bank) from paying more than six percent on debentures it might issue, and the bonds were not marketable at that rate. (Finding 2, Pet. App. 4a; App. 135.)

(2) Federal Reserve Regulations required Reserve Board approval if the total investment in the bank premises exceeded capital stock; the Reserve System indicated that it would not approve of Worthen owning the $9 million facility, either directly or through a subsidiary, because Worthen's capital stock was only $4 million. (Finding 2, Pet. App. 4a; App. 133-34; P.Ex. 317 at App. 597.)

Worthen then sought to develop a method which would provide Worthen with the use of the building, satisfy the requirements of Federal and state regulators, and attract the necessary capital. It was concluded that this could be accomplished by a sale of the building to an independent outside investor which would not be subject to either of the regulatory restrictions. The outside investor would then lease the building to Worthen for its occupancy and use. (Finding 3, Pet. App. 4a-5a; P.Ex. 5 at App. 328.)

The State Bank Department and the Federal Reserve System approved a proposal for the sale of the projected building and its leaseback to Worthen. Under the arrangement, Worthen would retain control of the adjacent parking facility, but it would sell the bank building and land for $7,000,000 and lease it back from the buyer. (Finding 3, Pet. App. 3a; P.Exs. 2 and 5, App. 322, 328.) The State Bank Department required that Worthen have an option to purchase the leased property at the end of the fifteenth year of the lease at a price set in the agreement (Finding 3, Pet. App. 3a; P.Ex. 6 at App. 366; App. 136, 138-39), and the Federal Reserve System required that the bank building be owned by an independent third party. (P.Exs. 4 and 38, at App. 326, 599; App. 133-34, 139.)

A number of investors were interested in owning the building on this general basis and submitted proposals to Worthen. Lyon heard of the arrangement at this time and submitted its first proposal on October 30, 1967.[1]

Taking the most favorable elements of various bidders' proposals (including a suggestion by Eastman Dillon-Union Securities Co. that sale of the land under the bank be eliminated from the sale to simplify establishment of equitable option prices; P.Ex. 39, at App. 601), Worthen prepared and submitted to the bidders a "Specification for Sale-Leaseback of Worthen Bank and Office Building." (App. 142-144; P.Exs. 12 and 13 at App. 348, 349). Anxious to acquire the building, Lyon proposed a reduction of rent of $21,000 a year for the first five years.[2] Lyon's proposal was accepted by Worthen, and Lyon was approved as an acceptable borrower by First National City Bank (FNCB) for interim financing, and New York Life Insurance Company as a permanent lender. Lyon in fact borrowed the money on these loans.

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[1] For competitive reasons, Worthen desired to get the building in operation as soon as possible and it had begun construction on a cost-plus basis on September 15, 1967, before the buyer was chosen. (App. 128-30).

[2] Finding 3, Pet. App. 5a; P.Ex. 14 at App. 352; App. 27-28. When New York Life refused to approve the reduction in rent, Frank Lyon and Worthen agreed that Lyon should pay higher than normal interest on an unrelated loan to pay off the acknowledged obligation of $105,000. App. 109-110, 146-147.

Final negotiations on terms began in December 1967 and were not completed until May 1968 (App. 29-30, 36-38, 85-86, 150, 215-216). Intensive discussions about all terms of the arrangement were carried on between Lyon and Worthen (App. 37-38, 121-22), with FNCB and New York Life participating on the financing issues. When the negotiations concluded, FNCB and New York Life required that the final terms be submitted to state and Federal bank regulators for final approval. The regulators approved the terms (P.Exs. 40, 41, 42, 43 and 44 at App. 609, 613, 618, 620, 622).

The result of the complex multi-party negotiations was embodied in a number of interlocking agreements. Worthen and Lyon executed: a ground lease under which Worthen leased the bank site to Lyon (P.Ex. 18 at App. 366); a sales agreement conveying the building to Lyon by general warranty deed (P.Ex. 25 at App. 508); and a building lease under which Lyon leased the bank building to Worthen (P.Ex. 19 at App. 376). Lyon also executed four agreements with New York Life to effect permanent financing of the building (P.Exs. 20, 26, 27, and 28 at App. 443, 523, 527, 571) (Worthen was a party to the first deed of trust, but not to Lyon's note or other agreements with New York Life). In addition, there were numerous agreements relating to interim financing among Lyon, Worthen, and FNCB (P.Exs. 21, 22, 23 and 24, at App. 462, 488, 490, 503) and a consent agreement between Worthen and New York Life which was designed to provide additional assurances to New York Life (P.Ex. 29 at App. 575).

Under the agreements, Worthen gave Lyon a ground lease for 76 years and 7 months on the site of the

bank building and sold the building to Lyon piece by piece, as it was completed,[3] for a total price of $7,640,000. Lyon then leased the building back to Worthen for a primary term of twenty-five years with options to extend the lease for eight additional five-year terms or a total of 65 years (P.Ex. 19 at App. 378). During the period between the end of the building lease and the end of the ground lease, total ownership, use, and control of the building and all improvements thereto were retained by Lyon (P.Ex. 19, Sec. 8.1 at App. 382-83).[4]

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[3] This arrangement was made because purchase of materials by the bank (by then a national bank) was not subject to Arkansas sales tax, pursuant to this Court's decision in First Agricultural National Bank v. State Tax Commission, 392 U.S. 339 (1968); and sale of the building elements to Lyon was not subject to sales tax, since it was a sale of real estate. (App. 32, 148). The Federal Reserve System would not permit Worthen to complete the building and then sell it to Lyon because Worthen's investment in bank premises could at no time, however short, exceed its capital stock. (App. 152-53).

[4] The rent schedule for the building was as follows (P.Ex. 19, Sec. 3.1 at App. 378-79):

First 11 years of the lease	$ 582,324
Years 12-25	613,157
Option Periods (Years 26-65)	300,000

Total building rent over the initial 25 year lease term equalled $14,988,648.

The ground rents to be paid to Worthen by Lyon were $50 per year for the first 26 years, 7 months, and thereafter (P.Ex. 18 at 367-68):

12/1/94 thru 11/30/99 (5 years)	$ 100,000
12/1/99 thru 11/30/04 (5 years)	150,000
12/1/04 thru 11/30/09 (5 years)	200,000
12/1/09 thru 11/30/34 (25 years)	250,000
12/1/34 thru 11/30/44 (10 years)	10,000

At the end of the 11th, 15th, 20th and 25th years of the lease, Worthen had the option to purchase the building at prices agreed on in the lease.[5]

The lease was a "net lease," under which Worthen was charged with the responsibility for operating the building, for insurance and repairs, and to keep the premises "in good order and condition: except for reasonable wear and tear." (P.Ex. 19, Sec. 7.1 at App. 382.)

To cover the purchase price, Lyon invested $500,000 out of its own working capital and $7,140,000 which it borrowed from New York Life on the permanent loan.

During 1968 and 1969, Lyon paid $453,483.81 interest to First National City Bank on the interim financing. In addition, it paid an aggregate of $58,952.00 for legal expenses, title insurance, audit expenses, and telephone and travel, in connection with the transaction.[6] It deducted $451,666.75 of these expenses on its tax return for 1969.

In December 1969, Worthen took possession. At that time, Lyon received the proceeds of the permanent

[5] The option schedule was as follows (P.Ex. 19, Sec. 20.1, at App. 419-420):

11/30/80 (after 11 years)	$ 6,325,169.85
11/30/84 (after 15 years)	5,432,607.32
11/30/89 (after 20 years)	4,187,328.04
11/30/94 (after 25 years)	2,145,935.00

[6] In the event that Lyon prevails in this case, it agrees that $32,996.19 of these expenses must be capitalized, and amortized over the period of the New York Life Insurance loan and building lease. The parties have stipulated the proper allocation of these expenses, and they are not in dispute. See Supplemental Stipulation, App. 7; Finding 4 of the district court, Pet. App. 10a.

loan on the building from New York Life, and it discharged the interim loan which had been made by FNCB. On its tax return for 1969, Lyon accrued $48,527.01 as rental income from Worthen for the month of December 1969. It also accrued a deduction for interest for one month, owed to New York Life, in the amount of $40,162.50; and it accrued depreciation on the Worthen building for one month in the amount of $51,618.79.

In auditing Lyon's return for 1969, the Commissioner determined without further explanation that Lyon "is not the owner for tax purposes of any part of the Worthen building." On this basis, he made three adjustments in Lyon's return, as follows (Finding 10, Pet. App. 7a-8a; P.Ex. 52 at App. 689):

1. The Commissioner disallowed all of the interest and expenses paid during the period of construction, in the aggregate amount of $451,666.75.

2. The Commissioner reversed the items for rent, and for interest and depreciation on the completed building during the month of December 1969. Specifically, he removed the accrued rental for one month from Lyon's income in the amount of $48,527.01. He disallowed the deduction for interest payable to New York Life for one month in the amount of $40,162.50; and he disallowed the deduction for depreciation on the Worthen building for one month in the amount of $51,618.79.

3. Finally, the Commissioner added an item of $2,298.15 to Lyon's income for 1969, as "accrued interest income."[7]

[7] These adjustments may be summarily stated as follows (Find-

The final item added to Lyon's income was based on the assumption that Worthen would exercise its option to buy the building after eleven years, on November 30, 1980, at the option price stated in the lease, which was $6,325,169.85. App. 288. In addition, the Commissioner determined that Lyon loaned $500,000 to Worthen, although Worthen gave no note, and did not otherwise obligate itself to pay $500,000 to Lyon on account of a "loan." On the basis of his determination that there was a "loan," the Commissioner then computed, or imputed, interest on this loan, as follows (P.Ex. 52 at App. 689):

"Option price of Worthen Building, 11/30/80	$6,325,169.85
Loan Balance to New York Life Ins., 11/30/80	5,521,813.36
Balance	$ 803,356.49
Cost	500,000.00
Gain	$ 303,356.49

ing 10, Pet. App. 7a-8a; P.Ex. 52 at App. 689):

1. Accrued rental income for 1 month from Worthen		$(48,527.01)
2. Accrued interest for 1 month owed to New York Life		40,162.50
3. Depreciation for 1 month on Worthen building		51,618.79
4. Expenses paid during construction:		
(a) Interest paid to FNCB	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

"This gain of $303,356.49 is considered the equivalent of interest income to be accrued over the (11) eleven-year period of the lease to the option date 11/30/80.

1969 Interest—$303,356.49 ÷ 11 ÷ 1/12 = $ 2,298.15

1970 Interest—$303,356.49 ÷ 11 = 27,577.86"

Lyon paid the resulting deficiency. After a refund claim was disallowed, Lyon brought this suit in the United States District Court for the Eastern District of Arkansas, to recover the deficiency paid for the year 1969. The taxes paid or due for 1968 and for 1970 and subsequent years are in abeyance pending the decision of this Court.

The district court held that the petitioner's depreciation and interest deductions were allowable. The court concluded that the legal intent of the parties had been to create a bona fide sale and leaseback, and that the arrangement substantively achieved this goal. The court rejected the notion that Worthen was acquiring an equity in the building through its rental payments, finding that the rents were reasonable throughout the period of the lease, and that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates (Pet. App. 2a, 6a).

In light of the bid competition for ownership, the district court rejected any negative inference to be drawn from the fact that the rentals combined with options were enough to amortize the New York Life loan and to pay Lyon a six percent return on its equity investment (Pet. App. 13a; 10a). The court concluded that it was highly unlikely as a practical mat-

ter that any purchase option would ever be exercised (Pet. App. 2a; 6a). Likewise the court rejected any inference built on the fact that it was a "net" lease which, the court noted, is a common form of long-term real estate lease (Pet. App. 12a).

Despite these clear findings, the court below reversed the decision of the district court. In its analysis, the court of appeals likened ownership for tax purposes to a "bundle of sticks" which represent the various benefits and burdens associated with ownership. The court undertook its own evaluation of the facts, and adopted the conclusion that "the taxpayer [Lyon] totes an empty bundle" of ownership sticks (Pet. App. 25a), i.e., that Lyon's ownership interest was too insubstantial to support the claimed depreciation despite the fact that Lyon retained all the risks and benefits if the options were not exercised, or if Worthen should become insolvent. Without much consideration, the court also disallowed the interest deduction on the same general basis.

SUMMARY OF ARGUMENT

The approach adopted by the court below in denying Lyon depreciation and interest deduction is inconsistent with sound tax policy.

Lyon and Worthen arrived at the sale-leaseback reflected here as a result of hard arms-length bargaining; the framework for their efforts was provided by banking regulations which precluded Worthen from owning the building. The particulars of the transaction arose out of competition between potential investors. Lyon was fully and solely liable as a matter of law on the loans, on which it paid and deducted in-

terest, and Lyon did in fact incur and pay the interim construction expenses which it deducted.

The arrangement is clearly not a sham. The District Court affirmatively found the option prices and rentals to be reasonable. In these circumstances, tax consequences should follow the parties' structuring of the transaction because there is no real reason to tax it otherwise. Moreover, there are numerous reasons *not* to restructure the transaction—including predictability and fairness to taxpayers involved in bona fide transactions, and efficiency in the administration of the tax laws. Although a recognition of these considerations can be discerned in prior case law dealing with sale-leaseback, in other "debt" characterization cases, and in analogous areas of tax law, there is none whatsoever in the reasoning or approach of the court of appeals. Compare *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); see also *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939).

Consideration of some of the main features of the transaction supports this conclusion as well. Lyon will sustain depreciation through decreasing option prices and decreasing rentals. Lyon is and will remain solely liable on the New York Life loan; the Government has ignored this obligation entirely because, in its analysis, the rent "flows through" Lyon to cover the obligation. But this analysis neglects the concrete importance of having such an obligation, and ignores this Court's ruling in *Commissioner* v. *Brown*, 380 U.S. 563 (1965). Similarly, the court failed to give any tax substance to obligatory banking regulations by holding in effect, that Worthen was the owner for tax purposes of a building Worthen could not legally own.

This approach was rejected by this Court in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).

The overall unreality of the Government's approach is manifest in its denial of deductions for interest. It does not dispute the fact that Lyon was solely liable to pay loan interest nor that it had done so. The Government nonetheless denied interest deductions and taxed Lyon for accrued "interest income" assuming, in the absence of any factual support or legal obligation, that Lyon had made a "loan" to Worthen which would mature and be retired by exercise of Worthen's option at the end of the eleventh year of the lease.

The court below should not have presumed to determine tax substance as a pure matter of law and disregard the clear and specific findings of the district court. This approach is at odds with proper appellate procedure, as well as other decisions (*see, e.g., American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974)), and it leads to such anomalous results as taxing Lyon for "phantom income" on a nonexistent 11 year loan. The district court's findings upheld the taxpayer on every point and should be upheld here.

The decision below, if allowed to stand, frustrates the bargained intention of the parties here and unsettles negotiations and planning by future taxpayers. Fairness, tax policy, and proper procedure all point toward reversal.

ARGUMENT

I. THE TRANSACTION SHOULD BE TAXED AS IT WAS STRUCTURED BY THE PARTIES – AS A BONA FIDE SALE AND LEASEBACK

Sale and leaseback arrangements are widely used as a flexible means of developing and controlling business property and dividing ownership interests in it. Typically, the sums involved are substantial, and the legal arrangements necessary to meet the particular situation are complex. Flexibility of form is an important part of the utility of the device. This flexibility is hampered to the extent tax consequences depend, as in the reasoning of the court below, on an after the event decision of a court, which is contrary to the intent of the parties as expressed in their bargain, and based on a rigid conception of what a "bona-fide" sale is, or an attempt to pull apart the elements of the transaction and assess them against an artificial standard of full ownership.

The bargain achieved by the parties here, with its balance of bartered benefits and responsibilities, and the good faith tax planning which inevitably affected the parties' estimation of these benefits, should not be frustrated unless there is some substantial reason based in tax policy to do so. The court of appeals recognized this principle explicitly, when it said (Pet. App. 23a):

> Since parties are generally free to dispose of property interests as they wish, the substance of a transaction usually derives from the parties' intent. Subject to certain policy considerations, the courts will respect the actual allocation of interests made by the parties even though it reduces or eliminates the tax liability. Helvering v. F. & R. Lazarus & Co., [308 U.S. 252]; Gregory v. Helvering, 293 U.S. 465 (1935).

But in attempting to apply the stated principle to the present case, the court below failed to relate its approach to any conception of tax policy, resting its result on an unstructured assessment of "burden and benefits" of ownership held by Lyon and Worthen.

In this case, there is no reason not to treat the sale and leaseback as bona fide. Hard bargaining at arms length has resulted in a complex distribution of the perquisites of ownership and use. The parties have not tried to "fool" the tax laws, nor is Lyon insulated from the wasting of capital, for which the depreciation deduction compensates, by any assurance, either legal or practical, that the options will be exercised or its investment otherwise returned in full. See Pet. App. 11a, and footnotes 12 and 28 *infra,* pp. 20-21, 48.

The specific issue here is Lyon's right to take depreciation and interest deductions. The court of appeals felt that this turned on whether the substance of the sale-leaseback was consonant with its form. "Substance over form" has two fairly clear functions in tax law. First, a party should not be allowed to use purely formal labels or maneuvers to frustrate the intent of tax provisions. *Cf. Gregory* v. *Helvering,* 293 U.S. 465 (1935). Second, economic decisions should not be distorted by attempts to achieve tax benefits which present no economic benefit. *Cf. Knetsch* v. *United States,* 364 U.S. 361 (1960). The negative side of the use of the doctrine is that upsetting the bargained intention of the parties will always involve costs. There is additional administrative effort for the Government in discerning and contesting lack of "substance." Taxpayers bear the burdens of uncertainty and unfairness in their efforts to plan, as well as in

frustrated plans and scrambled bargains; too extensive or uncritical a use of "substance over form" can be counterproductive, distorting economic decision-making rather than avoiding distortion.

If, as here, the parties have substantial non-tax motives for the transaction, and bargain in good-faith over details and consideration, the transaction is not a mere rearrangement of labels for tax purposes. If, as here, there is no differential in tax rate, or any special tax circumstance affecting one of the parties, then it is clear the transaction is not a sale of tax benefits, and it is unlikely that tax considerations disproportionately influenced the nature of the transaction or its terms. Finally, since the trier of fact determined the rents and option prices to be reasonable, there is no factual basis to infer that rent is building up equity, or that the lessee will inevitably exercise its options and become the owner of the building. Under these circumstances, there is no justification for scrambling the bargain between Lyon and Worthen, and injecting unnecessary uncertainty into the future planning of bona fide sale-leaseback transactions.[8]

Although the court of appeals denied that its opinion condemns sale and leaseback arrangements (which it characterized as useful and proper business devices), the court recognized that the features of which it saw as fatal in the Lyon arrangement are ordinary ele-

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[8] Cases involving gift leasebacks, often in intra-family situations, present a much greater danger of tax avoidance and wholly different policy considerations. Cf. Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965). Here the transaction is a commercial one bargained out at arms length, and the parties are subject to identical tax rates, so there is no effort to take advantage of a tax differential.

ments of valid sale and leaseback arrangements. The court also agreed that the same features are found in many cases in which sale and leaseback arrangements have been upheld. In effect, the court of appeals denied Lyon's entitlement to depreciation deductions on the basis of an unfocused overall comparison between sale-leasebacks and less sophisticated ways of holding property. By relying on the "cumulative effect" of various features which would otherwise be unobjectionable in a sale and leaseback transaction, the court made it impossible for a future tax planner to structure such an arrangement with any confidence or security, thus unsettling both the administration of the tax laws and the good faith efforts of taxpayers to comply with those laws.

Prior case law concerning sale and leasebacks, support Lyon's entitlement to depreciation and interest deductions. In other cases, the courts have put substantial emphasis on the intent of the parties in determining the practical effect of the parties' allocation of interests and the tax treatment of sale-leaseback transactions. Intent moreover is to be derived in light of the factual circumstances existing at the time the contract was made.

The principles are well expressed in *Benton* v. *Commissioner,* 197 F.2d 745, 752 (5th Cir. 1952):

> "There being here involved no restraint by law or public policy, the parties had full liberty to contract as they pleased. Whether what is in form a lease is in effect a conditional sale contract depends on the intention of the parties. The economic relation of the value of the property to the option price was only one factor to be considered in determining intent. Further that factor must

> be considered not as of the time for the exercise of the option, but rather in the light of the facts and circumstances as they existed at the time the parties entered into the contract. . . Within the limits of reason, the parties had a right to exercise their own judgment, and that of the Commissioner or of the Tax Court cannot be substituted therefor.
>
> If the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property."

These principles have long been solidly established in the case law [9] and they have recently been reaffirmed by the Fourth Circuit in *American Realty Trust* v. *United States,* 498 F.2d 1194 (1974), and by the Ninth Circuit in *Cubic Corporation* v. *United States,* 541 F.2d 829 (1976).

Proof can, of course, be offered to show that the transaction between the parties is not a bona fide sale-leaseback. If the rentals are shown to be unreasonably high, the court may conclude that the parties intended them to be partial payments of a purchase price. The option prices may be so low that it is inevitable that the option will be exercised and obvious that the par-

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[9] *See, e.g.,* Helvering v. Lazarus & Co., 308 U.S. 252 (1939); Meiselman v. Commissioner, 300 F.2d 666 (4th Cir. 1962); Western Contracting Corp. v. Commissioner, 271 F.2d 694 (8th Cir. 1959); Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955); Arkansas Bank & Trust Co. v. United States, 224 F. Supp. 171 (W.D. Ark. 1963); Kearney & Trecker Corp. v. United States, 195 F. Supp. 158 (E.D. Wis. 1961); and Reade Manufacturing Co., 32 T.C.M. 1225 (1973).

ties intended that it would be; the lessee may be "economically compelled" to exercise an option.[10] The legal "owner" may be a mere straw man rather than a wholly separate business entity with distinct goals and interests in entering the transaction.[11] If such proof is shown, there is some basis for a determination that a "sale" is a loan, or a "lease" a sale.

There was no proof here to contradict the district court's conclusions that the option prices were reasonable and that Worthen was unlikely to exercise its options at any time; nor did the Government ever offer any indication that Lyon's desire to diversify with a solid real estate investment,[12] or Worthen's

[10] *See* Lefevre, "The Tax Law of Lease Transactions Revisited," 53 *Taxes* 764 (1975), suggesting that this is the general rule, and cases cited therein.

[11] The Federal Reserve System required that the owner of Worthen bank be an independent outside investor, and rejected a plan for a wholly-owned subsidiary to own the building. P.Exs. 4 and 38 at App. 326, 599; App. 133-34. Frank Lyon Co. was (and is) in fact a substantial independent operation with assets of $12,225,612 and a net worth $3,818,671 at the end of 1968 (before including the bank building in its assets). P.Ex. 33 at App. 587.

[12] The principal motivating factor for Lyon was diversification, App. 48, 371. By far the major part of Lyon's business was distribution of home appliances, principally from RCA and Whirlpool. App. 19-20. Lyon considered it wise to diversify because they had saturated their primary market areas under their contracts with the manufacturers, App. 20; moreover, their contracts with their two major suppliers could be cancelled on thirty days notice. App. 48-49.

The Worthen investment appealed to Frank Lyon because a number of the directors were familiar with real estate investments; anticipated solidity of the investment and good cash flow, after tax in the early years, and before tax later; 2.9 million dollars anticipated income in the ten year period between the end of the building lease and the end of the lease in the underlying fee; disposal

need to stay within federal guidelines and preserve its capital position, were not the substantial motivating factors the district court found them to be in assessing the transactions.[13]

The tax law should not, in other words, hamper or distort the good faith planning of a bona fide transaction. The tax laws should, rather, take the transaction between the parties as it finds it, instead of restructuring it to suit a conception of the transaction which is at odds with the parties' practical understanding of the value and nature of the interests involved.

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of, or reimbursement for, the building at the end of the 75 year ground lease. App. 48-54; see also App. 260 (indicating that Lyon assumed that Worthen would not be able to exercise any of the options).

[13] The record shows that Worthen had at the time of the transaction and continues to have problems in keeping its capital up to that required by its growing deposits. App. 133-39; P. Ex. 4 and 38. "As rapidly as they are growing under the leadership they have I don't think that's going to stop any time in the foreseeable future. Like most aggressive banks, they are going to be in a capital bind." App. 260. In passing on the transaction involved here, Mr. Wyrick of the Federal Reserve System noted that Worthen's capital position had been a cause of concern in the past and urged the directors of the bank to review it frequently. P. Exs. 4 and 38 at App. 326, 599. In discussing the sale-leaseback, Worthen focused specifically on the capital advantages of the sale-leaseback in submitting the plan to the State Bank Commisioner. P. Ex. 5 at App. 329:

> "We realize that the sale and leaseback might be slightly more expensive in the long run. However, we are of the opinion that the advantages it offers us by not tying down our capital in land and building leaves us more leeway in the management of our bank and keeping our funds more profitably employed."

The capital problem has continued (as Frank Lyon expected that it would, App. 260) and makes it highly unlikely that any option will be exercised. App. 166-172. See also pages 30-34, below.

In an arms-length sale of a business, the parties' allocation of the purchase price among the tangible assets of the business and a covenant not to compete and goodwill will be followed by tax consequences. See *Commissioner* v. *Danielson*, 378 F.2d 771 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967). In the *Danielson* case on remand the Tax Court held that the contractual allocation of the parties was binding in the absence of fraud, duress, or undue influence. *Carl L. Danielson*, 50 T.C. 782 (1968). In *Benjamin Levinson*, 45 T.C. 380 (1966), the allocation in the sales contract was upheld although $142,000 of the total $147,000 price was allocated to the covenant not to compete. The Commissioner has formally acquiesced in this decision. 1966-2 Cum. Bull. 5. The divergent interests and non-tax motivations of the parties provide a protection against sham that is more effective and sensible than a microscopic examination of the equivalents exchanged. Both parties here are inextricably bound up in the ownership of the property, and it is more useful and sensible to recognize this fact than to attempt to tote up the elements of ownership each has.[14]

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[14] In *World Publishing Co.* v. *Commissioner*, 299 F.2d 614 (8th Cir. 1962), the court adopted a more realistic approach to the tax consequences of divided interests in property. There the taxpayer purchased from the original lessor property on which the lessee had built a building. The original lessor had made no capital investment in the improvements and was clearly not entitled to depreciation deductions. It was conceded that the lessee could depreciate the building as an improvement it had made to its long-term lease-hold. The issue was whether the taxpayer purchaser was entitled to a depreciation deduction on the basis of its investment in the property as a whole. Declining the Government's invitation to find a barrier in an asserted theoretical "anomaly" in two parties claiming depreciation, the court (per Blackmun, J.) looked to the purpose of the depreciation deduction—to reflect the wasting of capital investment—and concluded that the taxpayer as well as the lessee had a depreciable capital interest.

> "What is significant is that each taxpayer has a separate wasting investment which meets the statutory requirements for depreciation. To allow each to recover his own, and separate, investment is not, as is suggested, to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment. That each is concerned with the same building is of no relevance. Farnam has its lessee's cost of the structure and the present taxpayer has the portion of its purchase price attributable to the building. If two taxpayers own undivided interests in improved real estate, each may be entitled to depreciation. The situation here is not dissimilar." 299 F.2d at 622-23.

It is, in short, more important to recognize that Lyon has a real interest in the building than to parse out that interest in order to compare it either to Worthen's interest or to some artificial standard of full ownership.

In terms of the doctrine of substance over form, it is clear that the parties are not in any way attempting to take advantage of the tax laws, if, as the district court found, the rental rate and the option prices are reasonable. The Government here undertakes the burdensome and artificial exercise of weighing the exchange of equivalents in an arms length transaction to determine "true ownership", without any indication that the policy of the tax laws in general or of the depreciation deduction in particular is furthered. It is clear that this impractical and unrealistic method of determining tax consequences will encourage litigation and often distort good faith economic planning.

II. THERE IS NO BASIS FOR DISALLOWING THE DEDUCTION OF INTEREST WHICH LYON PAID ON MONEY IT BORROWED.

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

The record clearly establishes that Lyon borrowed money from FNCB on the interim loan, and from the New York Life Insurance Company on the permanent loan, and that it was liable for interest on these loans. FNCB's commitment letter stated the explicit understanding that "an acceptable real estate company [Lyon] would be the actual borrower" and that Worthen Bank "will not actually be guaranteeing our loan." (P.Ex. 16 at App. 356-57). Lyon, and Lyon alone, signed the note to FNCB. (P.Ex. 22 at App. 488-89).

Similarly the commitment letter of New York Life Insurance Company was addressed to Lyon (P.Ex. 17 at App. 358; App. 28-29). Lyon, and Lyon alone, signed a note evidencing its obligation (P.Ex. 26 at App. 523). Lyon gave a deed of trust on the building and on its lease as security for its obligation; Worthen joined in this deed of trust since it owned the fee of the land. (P.Ex. 27 at App. 527).

Thus, the record establishes clearly that Worthen did not owe money to FNCB or to New York Life, and that Lyon did. It was Lyon, and Lyon alone, which was liable to these lenders for interest on the debt, and eventually for principal payments. Lyon

is not only liable for the payment of the New York Life loan whether or not Worthen pays its rent, but also will remain liable on the loan in the event Worthen exercises one of its options to purchase the building and subsequently defaults in payment of the note. (App. 687-88, 207).

Lyon was in no sense an agent for Worthen. It was not subject to Worthen's domination or control. Indeed, the banking authorities had required that the owner of the building should be an independent entity, and had refused to approve an arrangement under which the building would be owned by a subsidiary of Worthen. (P.Ex. 4 at App. 326.)

In this situation, section 163(a) of the Code is clearly applicable. There was indebtedness, on which Lyon was solely liable on full recourse loans. Interest accrued on that indebtedness. Congress has specifically provided that "interest paid or accrued within the taxable year on indebtedness" is deductible. No justification is perceived for the action of the court below in denying the deduction for interest on either the interim loan with FNCB or on the permanent loan from New York Life.

Even if Lyon had been a wholly owned subsidiary of Worthen—which it was not—Lyon would have been entitled to the deduction for interest on *its* indebtedness. *Cf. National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949). There is no dispute that Lyon borrowed money from FNCB and from New York Life, and paid interest on both loans. Lyon was the only borrower. Worthen was not liable on the loan; it could not legally undertake the loans. Worthen did not pay any interest. It was under no obligation either to pay interest or to reimburse Lyon. The de-

cision below denying a deduction for interest which Lyon owed, and properly accrued, and for which Worthen was not liable, and could not legally be liable, cannot be supported.

III. CONSIDERATIONS OF TAX "SUBSTANCE" SUPPORT LYON'S CLAIM TO THE DEDUCTION OF DEPRECIATION, INTEREST, AND EXPENSES.

The economic reality of the Lyon-Worthen sale-leaseback is in sharp contrast with the characterizations presented by the Government and accepted by the court of appeals below.

The Government's picture of the transaction is basically a caricature, oversimplified to the point of unrecognizability. In the Government's view, Lyon has "loaned" Worthen the $500,000 equity cash which Lyon invested in the project, since, it is said, Lyon will receive this back at six percent interest when Worthen exercises one of its options. The Government argues that Lyon's liability to New York Life should be disregarded entirely; since rent from Worthen is equal to Lyon's liability to New York Life, the Government says that Lyon was acting merely as a "conduit" for payments between Worthen and New York Life. What this picture omits is any appreciation of the real and practical situation which faced the parties at the time they entered into this transaction, and of how the problems and uncertainties of that factual situation illuminate the terms of the transaction.

A. Under The Agreement, Lyon Is The Party Most Likely To Sustain The Burden Of Depreciation In The Value Of The Building Through "Wear And Tear" Or "Obsolesence."

The depreciation deduction is designed to reflect the economic loss suffered through exhaustion of a capital

asset, because of "wear and tear" or "obsolescence." I.R.C. § 167(a). See *e.g.*, *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939). In applying its "bundle of sticks" test, the court of appeals below looked to the operating rights and responsibilities which Worthen had been able to obtain in negotiations of the terms, and ignored the burden of wear and tear and obsolescence actually borne by Lyon.

The court emphasized that it was a net lease; that the investment credit was passed to Worthen;[15] that the level of lease payments and purchase option prices were designed to cover the loan obligation and provide a six percent return on Lyon's initial equity if the options were exercised; that there was no before-tax cash flow in the early years; and that Worthen shared significantly in division of condemnation awards. The court concluded: "The contract provides for no return to Lyon related to ownership risk." (Pet. App. 28a). It is, of course, the risk of wear and tear and obsolescence that is significant in terms of the depreciation deduction, and not operating risks which Worthen assumed or the limits which Worthen has been able to place on returns for Lyon's risks. Worthen's obligation to repair, maintain, and insure the building, explicitly excludes "reasonable wear and tear," the statutory definition of depreciation. I.R.C. § 167(a); P.Ex. 19, Sec. 7.1 at App. 382.[16] Full appre-

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[15] Since, I.R.C. § 48(d) permits a lessor to pass on the investment credit to a lessee at will, this factor should not, of course, have had any impact on the court's analysis.

[16] Worthen's responsibilities under the lease are distinct from Lyon's burden of depreciation in tax law as well as in fact. This is demonstrated by consideration of the tax consequences of any repairs, replacements, or maintenance expenses incurred by Wor-

ciation of the factual setting and prospects of the sale-lease transaction makes it clear that Lyon continues to bear this burden.

1. *Option Prices and Rentals.* The option prices and rentals through the 25-year period of the initial lease term are geared to the totals necessary to provide Lyon with current funds to repay the New York Life loan and, *if one of the options is exercised*, achieve a six percent compounded return on its initial equity investment. This does not mean, of course, that the option prices and the rentals were not fair and reasonable as the district court found them to be. C. V. Barnes, an independent realty expert, testified that the option prices and rentals were reasonable estimates of market values (App. 236-237, 240-242),[17] and the district court found that they were the reasonable estimates of market price arrived at as a result of hard, arms-length negotiations.

The Government offered no evidence to the contrary. Its position amounts to a declaration that rents and options geared to six percent return on initial equity

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then. Some of these expenditures could be for improvements, and could be capitalized and depreciated by Worthen, I.R.C. § 178, Reg. § 1.167(a)-4; others could be deducted as ordinary and necessary business expenses in the year of expenditure. See generally Journal-Tribune Publishing Co. v. Commissioner, 348 F.2d 266 (8th Cir. 1965). The expenditures would, in any case, whether incurred by Lyon or Worthen, be distinct from the underlying capital interest in the building which would continue to be depreciated no matter who incurred the additional expenses or capital investments. See also note 14, supra, pp. 22-23.

[17] "[T]he square foot rental rates related favorably to the rental rates being charged in other comparable office buildings." App. 236.

cannot, as a matter of law, be a valid estimate of fair and reasonable values. This position ignores the reality of the bargaining process. In attempting to estimate fair option prices and rentals at times far in the future, and to give the security to the lenders and the assurances to the banking authorities which each required, it is natural that bargaining would take place around the area of the amount necessary to retire the New York Life loan.[18] The variable factor in the negotiations was the amount of return to Lyon above the amount to retire the loan. The district court reasonably found that the resulting return, arrived at through arms-length negotiations, was a good faith effort, and a fair success, as an estimate of market values at the times in the future. (Findings 6 & 7, Pet. App. 5a, 6a). Presumably if the parties' estimate of future values had been different, the six percent "interest" figure, on which the Government relies so heavily, could have been either greater or lesser.

The option prices and rentals that were arrived at not only represent reasonable estimates of values, they show a downward trend which is, according to the independent realty expert who testified at the trial, quite compatible with the lessening value of an aging building. (App. 240-241). It is the Lyon Company which sustains the economic loss associated with the age of the building in collecting the decreased ren-

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[18] As Mr. Barnes testified, App. 239:

> "Again, this is a general practice in the industry. When you make a lease or sale leaseback you have to have some number upon which the negotiations take place over. It's very common in build-to-suit property for the parties to agree on a dollar figure and then for the lessee to pick up any additional expense in the form of leasehold improvements."

tals or—if the options are exercised—the decreasing option prices paid for it.

In *Northwest Acceptance Corp.*, 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974), the Tax Court upheld the owner-lessor's claim for a depreciation deduction against a Government contention that the taxpayer did not have a substantial enough economic interest in the leased property to support the claim. The court distinguished cases in which the taxpayer's interest had been found to be too insubstantial to justify depreciation in the following terms:

> Both cases, however, are clearly distinguishable for the taxpayer in each stood no risk of investment loss for the years in which the depreciation deductions were claimed. In both instances the *taxpayer was guaranteed a sale of the rented property at the end of the rental term at a price equal to the fair market value of the property or the taxpayer's investment at the beginning of the rental term.* On the other hand, in the instant case the sales prices under the dealer repurchase agreements and the purchase options are considerably lower than the value of the equipment at the consummation of the leases. *The depreciation of the rented property during the lease term, as reflected in the lower option prices, is certainly deductible by someone, and since we have determined petitioner to be a bona fide lessor, it is entitled to the deductions.* 58 T.C. at 849-50 (emphasis added).

Lyon has no assurance, or even a practical expectation, that the options will be exercised, though it is certain the option prices and rentals decrease over time.

2. *The 25-Year Breakpoint.* Both the independent realty expert and the president of Worthen Bank testified that functional obsolescence or other factors would make it likely that Worthen Bank would need another new building by the end of the 25-year period. Mr. Penick, president of Worthen Bank, testified that: "25 years is about the maximum it [a bank] can stay in any one place in a functional building." (App. 171.)

> Q. "Do you think Worthen Bank at the end of 65 years would still be in that building?"
>
> A. "Not if history repeats itself. I think we probably would have gone through another building besides this one by that time." (App. 172.)

Mr. Barnes, the independent realty expert, indicated that the principal thing in determining value of a building in the far future is "functional obsolescence, not its physical situation."

> "[A]fter they [other buildings in Little Rock with which he was familiar] were some 25 or 30 years old they had to have some extensive money spent on them to cure a problem, and certain functional problems you couldn't cure. So the result is that that type of age building rents for less money which results in the value being less than it would if you could rent it for what a class A building would rent for." (App. 241.)

It is at this point in the life of the building, in 1994 25 years down the road, that Worthen Bank becomes free of its absolute lease obligation. Succeeding renewals of the lease up to the end of the total option periods (65 years in the aggregate), come at 5 year intervals, indicating the increased uncertainty of the parties that the building will continue to meet Worthen's needs. In 1994 Worthen can (1) buy the building at a purchase price of 2.1 million dollars, (2) continue to rent the building at reasonable rentals, or (3) it can

seek out new quarters, all at its own choice. The testimony of Worthen and Lyon, as well as that of Mr. Barnes, the independent realty consultant, and the findings of the court, all indicate that exercise of the option at 25 years, or at any other time, is the least likely possibility. (App. 136-138, 164-172, 251, 261.)

Since Worthen is, at the end of the 25-year term of the lease, free of any obligation to rent or buy, it is also free to negotiate a new and lower option price if the value of the building has declined below the figure specified in the contract. In short, the burden of depreciation below that value is all borne by Lyon rather than Worthen. In the option prices and reduced rentals, Frank Lyon will bear the burden of ordinary depreciation of the building in accordance with the parties' estimates of future value. If the depreciation in value is, however, for some reason extraordinary, Frank Lyon must bear that burden as well, by selling at a price less than the option price, by renting at rentals less than the option rental, or by taking possession and control of a building that is much devalued if not functionally obsolescent.

The Government argued below that Worthen would not simply walk away from the "equity" that it has built up on the building at the end of 25 years. This line of argument, of course, begs the question. At the end of the 25-year period, Worthen will act in its own best economic interests. The building may have depreciated in value or usefulness to Worthen to a point below that reflected in the rentals and option price stated in the contract, or Worthen may well, as we have seen, want a new building. If Worthen has paid no premiums in rentals in return for a lower than market option

price (and the testimony and findings below indicate that it did not, App. 236), then Worthen loses nothing by walking away at the end of 25 years, and Mr. Barnes and Mr. Penick both indicated that on the basis of their experience in the field, this was not at all unlikely. App. 171-72, 251-52. In any event it loses nothing by walking away at the end of 25 years, if the agreed upon option price is greater than the building's current worth to Worthen. It will not buy unless the building is then worth more than the option price.

If the building depreciates in value to the level below the option prices it will be Lyon which bears the financial burden of depreciation due to wear and tear, obsolescence, or merely an unfortunate change in the neighborhood. The inescapable conclusion is that Worthen has passed all risks of depreciation to Lyon while retaining for itself operating control, and only such other operating and casualty risks as any long-term lessee might have.

None of these possibilities is offered as a certainty. The range of possibilities, however, and the range of Lyon's consequent exposure to loss through depreciation, should indicate the spuriousness of the Government's certitude about what will happen 11 or 25 years down the road.

When we look to the factual basis of this certainty about real estate in general and the long term real estate market in Little Rock, Arkansas, in particular, we find that it is extremely narrow. The field agent of the IRS who initially determined that Worthen bore nearly all the burdens and benefits of ownership had only slight experience in real estate transactions and next to none in the sale-leaseback area. (App. 274-76.) The

court of appeals in assessing the same burdens and benefits, felt that it could do so on the basis of the documents themselves without any apparent appreciation of the factual probabilities and concerns that animated the parties. See also section IV *infra,* pp. 46-54.

B. The Spurious Nature Of The Commissioner's Action Is Clearly Shown By The Inclusion In Lyon's Income Of Imputed "Interest" From Worthen.

As indicated in the statement above (pp. 9-11), one of the elements in the Commissioner's adjustment of Lyon's taxes for 1969 was the inclusion of "accrued interest income" in the amount of $2,298.15. This figure was arrived at by an involved and highly artificial process. It may fairly be called "phantom income."

In the first place, it was *assumed* that Worthen would exercise its option to buy at the end of eleven years, or on November 30, 1980. The option price on that date is $6,325,169.85. On that date, if everything goes on schedule, the payments due from Lyon to New York Life Insurance Company will be $5,521,813.26. The difference is $803,356.49. Against this figure, the Commissioner allowed $500,000 as the amount of Lyon's "loan" to Worthen. This left a balance of $303,356.49. The Commissioner said that this sum "is considered the equivalent of interest income to be accrued over the (11) eleven-year period of the lease to the option date 11/30/80." Accordingly, the Commissioner divided this figure by eleven (for the years), and then by twelve (to get one month), and obtained $2,298.15, which he determined was "accrued interest income" from Worthen to Lyon for the month of December 1969.

It is hard to think of anything in the tax law more artificial and unreal than this. There was no loan from

Lyon to Worthen. Lyon paid no money to Worthen. Worthen undertook no obligation to exercise the option on November 30, 1980. Yet, the Commissioner says that there is "interest" running from Worthen to Lyon, and that a proportionate amount of this accrued in 1969. To find an accrual where there is no loan, no indebtedness, and complete uncertainty as to future events is surely novel.

It was more than fifty years ago that this Court established the basic rule for accrual in *United States* v. *Anderson,* 269 U.S. 422 (1926). In that case, the Court held that an item (there a tax) accrues when "all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it" 269 U.S. at 441. See also *Spring City Foundry Co.* v. *Commissioner,* 292 U.S. 182, 184-185 (1934), and section 1.446-1(c)(ii) of the Income Tax Regulations, which provides:

> "(ii) *Accrual Method*
>
> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income . . ."

Clearly, the present case does not come within this rule. Quite apart from the fact that there was no debt for money loaned by Lyon to Worthen, and no obligation to pay interest, the receipt by the taxpayer here of the alleged interest income is entirely dependent upon whether an unrelated party will ever exercise any one of several options to purchase property. In this situation, the taxpayer's right to the alleged interest income is surely not "fixed," and is thus not accruable. The district court made explicit findings to this effect

and rejected the attempted accrual, calling the "loan" theory "completely untenable both in fact and in law."[19] (Pet. App. 11a, 13a.) Indeed, it is an illustration of the extent to which artificiality can enter into tax determinations when they depart from the basis of legitimate transactions as the parties have structured them. There should be no such "phantom income" in this very real situation.

The unreal nature of the Government's approach, exemplified in this otherwise small matter of the "accrued interest income," permeates its handling of the whole case. Lyon was in fact an independent operator. It bought property, put in some of its own money and borrowed the rest of the money to pay for the property and rented it to a tenant. The Government's effort to rewrite this transaction in different terms finds no support in the tax laws, and would lead to great uncertainty in tax planning and tax administration, and would

[19] It is illuminating to consider the analytical process that went into the initial determination that the arrangement here was a "loan" which would be paid by exercise of the 11th year option. On cross-examination the I.R.S. representative who initially made this determination testified that he assumed that the option would be exercised at the end of the eleven years because "that was the first option period for it to be exercised." When asked on what basis he had assumed it would be exercised at all, he replied: "On the basis that it was a loan." (App. 288). He had previously stated that his analysis was the result of several factors, no one of which was determinative, but when confronted with the question of the impact on his "loan" theory of proof that Worthen would at no time exercise the option: "You mean if at no time Worthen exercises the option? If Frank Lyon continues to be the owner of the building per se? It wouldn't be right. It wouldn't be valid." (App. 282). He later qualified this statement with regard to the impact on his analysis of the situation as a whole by saying he "would have to study it some more." (App. 285). Compare the text at pp. 48-49, infra, and nn. 28 and 29.

inevitably add to the amount of litigation brought before the courts.

C. The Government's "Conduit" Theory Of The Loan Payments To The New York Life Insurance Company Is Inconsistent With The Legal Obligations Of The Parties, With A Practical Construction Of The Effect Of Those Obligations, And With This Court's Decision In Commissioner v. Brown.

1. Lyon is, and will remain until full payment, solely liable on the $7.14 million permanent loan from New York Life Insurance Company. The Government dismisses this as unimportant because rent payments will cover the balance of the note, and Worthen obligated itself to pay rent throughout the 25-year period in which the loan is to be paid back. But the loan was certainly far from unimportant to Lyon. Mr. Lyon expressed shock at the idea that his company would make itself liable on a loan of such size merely as an accommodation party or as a straw man to any one. He stressed the necessity of showing the liability on the firm books (with its consequent impact on firm standing and credit) and noted in particular the close watch that Lyon's distributors, RCA and Whirlpool, kept over its books (App. 259). If Worthen defaults, Lyon remains liable on the loan and must pay it whether the rent comes in or not. (P.Exs. 20, 26 at App. 443, 523). The Government disregards this possibility, though the parties dealt with it at length. In effect, the Government contends that Lyon has nothing at risk because the rent payments flow through to cover Lyon's loan obligations.[20] By disregarding Lyon's independ-

[20] This, of course, is a standard incident of any long term lease. The lessor will always look to the rental during the primary term of the lease to cover its liability on its own financing obligations. And any lender will always insist that the rental payments be sufficient to cover the payments on its loan.

ent liability, the Government is able to argue that only Lyon's initial equity investment of $500,000 is ever at risk and that Lyon will surely recover at least that amount.

This "flow-through" contention is quite similar to the position which this Court rejected in the case of *Commissioner* v. *Brown*, 380 U.S. 563 (1965). In *Brown* the family-owned Brown Company was sold to the New York Cancer Institute, a tax exempt organization for a price of $1.3 million, paid by the charity's note. The Institute then leased the assets of the company to a second corporation owned by the Brown family's lawyers and having the same operating personnel as the original Brown Company. The new company paid the Institute 80% of its gross profits for the use of the leased assets. The tax exempt organization agreed to apply 90% of this amount to the $1.3 million note owed to the Brown shareholders.

The benefit from the point of view of the Brown shareholders was that before the transaction the profits which resulted from the use of the assets were taxable to them as ordinary income. After the transaction they received only 72% of those profits, but: the new company was able to deduct the rentals paid to the Cancer Institute; the Cancer Institute paid no taxes on the monies it received because it was tax exempt; and the Brown shareholders treated the 72% of profits which they received as capital gain on the sale of the company, subject to capital gains tax rates rather than ordinary income rates.

The Commissioner asserted that the transaction was a sham because the Brown Company personnel and shareholders retained so much economic interest and control over the assets in question.

The Tax Court rejected the Commissioner's contention noting that the parties had bargained in good faith at arms length; that the price was in a reasonable range with the assets involved; that there was a real exchange of economic benefits in the transactions; and that the Institute was found to be motivated to a great extent by the residual value of the assets. The court of appeals affirmed.

Before this Court, the Commissioner shifted his ground somewhat. He argued that the risk of the transaction remained completely on the seller, the Brown Company, since the Institute had invested nothing itself in buying the assets and retained no independent liability for the purchase price if there were no profits. This Court rejected the argument that there was no sale because there was no risk shifting and that there was no risk shifting because the purchase price came only from income.

The Government is pressing the same argument here that the Court rejected in *Brown* even though (1) Lyon's obligation to pay the note to New York Life is unconditional, and (2) Lyon retains substantial elements of risk, and has interests in the building which are independent of the interests of either Worthen or New York Life.

From the point of view of economic substance the present case seems similar and indeed much stronger than *Brown*, not only because Lyon takes on independent risks, but also because the sale-leaseback's utility does not depend upon the tax consequences.

2. Moreover, there is a strong likelihood that the lease will terminate after twenty-five years, and that Lyon will then have full ownership of the building. Worthen

has no obligation after twenty-five years, unless it exercises an option to renew. Substantial testimony below indicated that Worthen may well seek new quarters at the end of 25 years (App. 171-172; 241-242); the combination of Worthen's capital needs and its need for up-to-date accommodations may leave Lyon in complete control of the building for the remaining 50 years of the ground lease.[21] The president of the bank testified that 25 years was about the maximum a bank could stay in one place (App. 172) and the bank is free to leave the building after 25 years, or at the end of any subsequent 5 year renewal period.

In any event, under the lease, Lyon will come into absolute control of the building at the end of all the lease and renewal periods. In the final negotiation over the terms of the sale and leaseback and related agreements, Frank Lyon Company bargained for and got a 10-year extension of the ground lease beyond the period covered by Worthen's options to renew. The ground rent drops from $250,000 per year to $10,000 per year for the remaining 10 years of the ground lease. Even if Frank Lyon does not come into control earlier, during this 10-year period the company will be free to deal with the building at a drastically reduced ground rent and to use it as it pleases. The improvements made by Worthen, which necessarily would be extensive, would then be retained by Lyon (P.Ex. 19 section 8.1 at App. 382-383). Lyon anticipated an income from the building of roughly $2.9 million dollars over this ten-year period. (P.Ex. 36, at App. 595; App. 35, 51.)

[21] Lyon indicated that increasing equity in the Worthen building was an important factor in buying the building. App. 50.

Accumulated appreciation or depreciation of the building will be borne by Lyon whenever it comes into total control in renting and operating the building or in making the repairs or arrangements necessary to do so. Neither the court of appeals nor the Government has dealt in any satisfactory way with this 40-year period of potential complete control by Lyon, or the 10-year period of absolute control by Lyon over the building and over all the subsequent improvements made by Worthen. It is certainly inconsistent with characterization of Lyon as a mere conduit.

3. There has been some dispute in this case about residual interests in the building at the end of the ground lease. Lyon maintains that it will continue to own the building at the end of the lease,[22] and the Government has maintained that the building will revert to Worthen: that Worthen has retained control throughout the 65-year period by its options, and by reverter at the end of the ground lease. The court of appeals, while indicating that it need not decide the issue, pronounced that Lyon's claim was "dubious." (Pet. App. 27a, n.6.) The issue is significant because if Lyon is the owner of the building, Lyon will be entitled to sell or lease the building at fair value. If it is unable to come to an arrangement with Worthen on the ground lease, it will be entitled to an equitable adjustment under Arkansas law. Moreover, Lyon's residual interest in the building is, like the 10-year period in which Lyon is entitled to deal with the building free of the lease, totally inconsistent with the picture of Lyon as an accommodation party or straw man.

[22] This was Lyon's explicit understanding at the time it entered the arrangement, based upon legal advice from counsel. App. 36.

The common law rule and Arkansas case [23] relied upon by the Government in its brief in opposition to the petition for certiorari stand for a proposition—that improvements by a lessee revert to the owner of the land at the end of the lease unless the lease provides otherwise—which is simply not applicable when the improvement has been specifically sold, without reservation of rights, to the lessee; nor is there any equitable reason why it should. Here the building was constructed by Worthen as the owner of the land and sold separately from the land by a sales agreement and a general warranty deed to Lyon as the lessee of the land without any reservations of reversionary rights, in clear recognition of the separate ownerships of the land and the building. (P.Ex. 25 at App. 508.) This negates any suggestion that Lyon as lessee of the land (or Worthen as lessor) constructed improvements on the demised premises with the intention, silent or explicit, that the improvements would automatically revert to the ground lessor on the termination of the lease.[24] The instruments executed by Worthen and Lyon not only reflect a clear recognition of Lyon as owner of the building, but also a clear intent that title to that building would return to Worthen only in the event Worthen exercised one of its options to purchase.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Cravens,* 33 Ark. 376

[23] Williams v. Kirby School District No. 32, 207 Ark. 458, 181 S.W. 2d 488, 490 (1944).

[24] Compare the treatment of improvements in the building lease, P.Ex. 19, Sec. 8.1, at App. 382-83, which provides explicitly that improvements made become the property of the building lessor, Lyon.

(1878), the Arkansas Supreme Court resolved the dilemma of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case of *Witherspoon* v. *Nickels,* 27 Ark. 332 (1871), and was cited with aproval in *Butler* v. *Adler-Goldman Commission Company,* 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sanger,* 108 Ark. 154, 161, 156 S.W. 1020, 1022 (1913). It has never been overruled or questioned.

The Government and court of appeals have implied that Worthen retained title to the land in order to ensure complete control of the building through its recovery on the expiration of the Ground Lease. To the contrary, Worthen first planned to sell and leaseback both the land and the building (P.Ex. 2 and 5 at App. 322, 328), and the State Banking Department required that Worthen have an option to repurchase the land and building after 15 years at a presently "agreed upon figure" for the building and "the land at the cost at which it was" acquired. (P.Ex. 6 at App. 336-37.) [25] During subsequent negotiations with potential investors, the sale of the land under the building was eliminated from the proposed sale-leaseback transaction at the suggestion of Eastman Dillion, Union Securities Co. (one of the potential investors), solely in order to simplify the establishment of equitable option prices for the building alone on the various option dates (P.Ex. 39 at App. 601).

Worthen conveyed to Lyon absolute title to the building by a general warranty deed subject only to options

[25] It is questionable whether the State Bank Department would have approved an option price based on fair market value rather than an "agreed upon figure" or dollar value.

to repurchase. The district court found that "it is most unlikely that Worthen will exercise the option [to repurchase] at the end of eleven years, or, indeed, at the end of any subsequent option period" (Pet. App. A 2a). It is clear under Arkansas law that the building will not revert to Worthen at the end of the 75-year Ground Lease. Consequently, it is highly unlikely that ownership of the building will ever revert to Worthen, in which case Lyon is clearly entitled to the deduction for depreciation.

4. Various other features of the lease transaction indicate that Lyon was not a mere conduit. For example, Lyon could at any time sell the building to another purchaser. Mr. Lyon testified that he had been approached to do so on several occasions and had refused because he thought the investment a good one. (App. 261-62, P.Ex. 51 at App. 687.) [26]

Moreover, the conduit theory adopted by the court below will in no event be applicable to the interest paid by Lyon to FNCB on the interim loan during the period of construction. There is no payment by Worthen to Lyon which can, in any sense, be regarded as flowing through Lyon from Worthen to FNCB.

D. Commissioner v. First Security Bank Of Utah Precludes A Finding That Worthen Owns The Bank Building For Tax Purposes.

In determining that Worthen is the owner of the Bank Building for tax purposes, when state and federal banking regulations prevented Worthen from being the owner, the Commissioner ignored the effect of

[26] Lyon agreed to protect Worthen from an unacceptable owner coming into control of the Frank Lyon Company. P.Ex. 50. But this did not cover ownership of the building itself.

this Court's holding in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).

In *First Security Bank*, the Commissioner attempted to allocate income to the taxpayer based on its activities in referring borrowers to insurance companies owned by the same holding company as the bank. The holding company also controlled a management company, an insurance agency, and an insurance company. The Commissioner acted pursuant to § 482 of the I.R.C. —which allows the Commissioner to reallocate income among businesses owned by the same interests if he determines it is necessary to prevent misallocation among these businesses and evasion of taxes. The Bank did not receive any commissions for this referral because it was prohibited by law from doing so. Nonetheless, the Commissioner allocated amounts equivalent to normal commissions to the bank and away from the related companies which retained those amounts. The Court rejected this attempt.

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving." 405 U.S. at 403.

The present case involves deductions rather than income, but it would similarly be illegal for Worthen Bank to own the building here in question. The Commissioner's action here, as there, amounts to a denial that banking regulations have tax "substance." The banking regulations in each case serve to make it clear that the arrangement in which the taxpayer was involved was not a device merely to avoid taxes, but an arrangement with an independent justification and rationale.

Nor were the banking requirements in this case merely formal. Mr. Wyrick of the Federal Reserve System indicated to Worthen that ownership of the bank building by a wholly-owned subsidiary would not satisfy Federal Reserve requirements because it would be the practical equivalent of ownership by Worthen itself. See also P.Exs. 4 and 38 at App. 326, 599; App. 133-34, 139-40.

IV. THE TRANSACTION SHOULD BE TAXED IN ACCORDANCE WITH THE DETAILED FACTUAL FINDINGS OF THE DISTRICT COURT.

A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. In denying interest and depreciation deductions to Lyon, the court of appeals evaded the specific factual findings of the district court.

The trial court found that the rents were reasonable throughout the period of the lease (Pet. App. 13a, 5a-6a), and rejected the notion that Worthen was acquiring an equity in the building through its rental payments. (Pet. App. 2a, n.2.) The trial court also found that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates. (Pet. App. 6a.) The trial court further concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised. (Pet. App. 2a, n.2.) Finally, the trial court made the ultimate finding that this was in fact a sale and leaseback. Specifically, the Court said (Pet. App. 1a-2a):

> "After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws."

These findings were not based on speculation or on a conclusory reading of the documents alone. The trial court heard specific supporting testimony concerning—

1. the motives of the parties upon entering into the transaction; see footnotes 12 and 13, *supra*, pp. 20-21.

2. the capital and business circumstances of each (App. 19-21, 48-50, 127-28, 130, 131, 135, 137, 163, 166-67, 213, 218-19, 238);[27]

3. the nature and details of the negotiation (among the parties, the lenders, and the banking authorities) (App. 23-29, 85-86, 91, 142-146, 148-49, 150, 162-164, 272-273, 311);

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[27] Mr. Dover, who represented New York Life Insurance Company in the negotiations, testified that the negotiations took so long—from December 1967 to May 1968 even though the basic format had been agreed upon—because:

> "Well, there was just considerable give and take, bargaining, negotiating among the parties. I assume these documents are in evidence. There were volumes of documents and were negotiated chapter and verse, paragraph by paragraph, almost word for word." App. 85-86.

4. the comparability of the rents and options to market prices (App. 31, 226-29, 235-36, 239-40, 241); and

5. the practical likelihood of various eventualities as they presented themselves to the parties at the time they entered into the transaction (App. 35-36, 165-173, 213, 250-51, 260).[28]

It also explored in detail the nature of the overall relationship between Lyon and Worthen and the numerous documents. This factual display fully supported Lyon's contentions about the nature of the transaction.

The Government offered no testimony whatever on the "reasonableness" of the various option prices and rentals; it offered no testimony which contradicted the parties' picture of the nature and motivations of their transaction; and it offered no factual display whatever about the prospects of a building such as Lyon's, or about the real estate market the building was in. The only testimony offered by the Government was that of the revenue agent who admitted to little experience with the real estate transactions, and next to none in the field of sales and leaseback. If he had any particular

[28] Both Mr. Penick of Worthen Bank and Frank Lyon Company emphatically denied that there was any agreement of any sort that Worthen would exercise one of its options and expressed doubt any option would ever be exercised. App. 165-172 and 260. As Frank Lyon said:

> "At that time I didn't think they could exercise it. I still hold that opinion. Of course they have final say on that, not me. We went into it on the basis they couldn't then. I don't think they could now. I don't know as much about it as they do, however." App. 260.

knowledge of the market and prospects for office buildings in Little Rock, it does not appear in the record."[29]

The court below evades the specific factual findings of the District Court by invoking the "substance over form" doctrine and characterizing entitlement to depreciation deductions as a legal question which is to be determined by interpretation of "undisputed written documents." The intent of the parties, the Court of Appeals said, is only relevant insofar as it affects the allocation of ownership interests which is spelled out in the contract documents. It is this allocation of interests which is "the substance of the transaction."

Lyon does not seek to controvert the long established principle of tax law that substance is to prevail over form. However, determination of the "substance" of a transaction of this sort has been consistently interpreted to require a factual appreciation of the importance of the ownership interests which are being allocated. *See, e.g., American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); *Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (9th Cir. 1974); *cf. Commissioner* v. *Duberstein*, 363 U.S. 278, 289 (1960).

[29] The situation which confronted the district court is similar to that addressed in *Kearney & Trecker Corp.* v. *United States*, 195 F. Supp. 158, 162 (E.D. Wis. 1961):

> "These findings of reasonableness of both the option prices and the rental are not only affirmatively supported by the credible testimony and documentation, but negatively by the failure on the part of the United States to produce any witness who would state that the option prices were so low, when compared to the market value of the leased property, as to indicate that lessees exercising their options to purchase had previously acquired an equity in that property, or that rental payments were so high when compared with the actual use value of the leased property, as to indicate that they were, in reality, payments on an installment purchase. Under these circumstances we must hold that no equity is being acquired."

As the Tax Court said in *Reade Manufacturing Co.*, 32 T.C.M. 1225 (1973):

> "[T]he proper standard for determining the Federal income tax consequences for this transaction is the intent of the parties and the substance of the transaction resulting from their intent. The resolution of this narrow issue, purely a factual one, must be determined from all the facts and circumstances surrounding the agreement when it was made." 32 T.C.M. at 1230.

The court below maintains, in effect, that it can determine whether documents which purport to be a lease are in actuality a sale or a loan by a purely "legal" reference to the documents themselves regardless of factual determinations whether the option price was substantial and fair, whether the rentals for the property represent good faith estimates of rental value (as opposed to purchase installments or loan repayment), or whether as a factual matter the purported lessee is going to exercise its options and gain full ownership.

Although the Government and court of appeals invoked the "substance over form" doctrine, the assertion that an appellate court can determine the substance of the transaction solely by reference to the formal documents and disregard factual findings below is totally contrary to the rationale of that doctrine and to Rule 52(a) Fed.R.Civ.Pro.[30] As this Court stated in *Helvering* v. *Lazarus & Co.*, *supra:* "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." (308 U.S. at 255.) The court below looks beyond the label of the transaction—but not so far as the economic reality of the interests allocated.

[30] "If the transactions were bona fide leases and the taxpayer remained the owner of the equipment, then it was entitled to a deduction for depreciation, Int. Rev. Code of 1954 § 167, and an investment credit, Int. Rev. Code of 1954 § 38, both of which the taxpayer had taken. It would not have obtained those tax advantages were the agreements in question contracts of sale or conditional sales. The issue is essentially a factual one. As the Tax Court pointed out, '[t]he factual issue presented here is an extremely close one, making the decision difficult.' That court resolved the contest in favor of the taxpayer, holding that the agreements were leases. Weighing the same evidence we might well have decided the case differently notwithstanding the decision in *Lockhart Leasing Co.* v. *United States*, 446 F.2d 269 (10th Cir. 1971), upon which the Tax Court so heavily relied. But our standard of review requires us to affirm unless the decision is 'clearly erroneous.' *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960)." *Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (other citations omitted).

The conflict between the approach of the court below and previous courts of appeals is shown most clearly by consideration of the recent Fourth Circuit case of *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974). In *American Realty Trust*, the Government pressed two contentions on the court. First, Government counsel suggested that the proper characterization of the substance of the transaction was "essentially a factual matter," and that *American Realty Trust* had not proven by a preponderance of the evidence that the transaction involved was a bona fide sale and leaseback and not a financing arrangement. Second, the Government maintained that the question of the bona fides of a sale-leaseback was a legal question and could be decided as such on appeal without regard to the findings of the court below. In rejecting both

contentions, the court relied heavily on the facts as found by jury verdict in the district court. With regard to the issue of the preponderance of the evidence the court stated:

> "We emphasize that appellate review of a jury verdict presents no occasion for the reviewing court to sift and weigh competing factual assertions, to draw its own inferences from contradictory evidence, or to choose between the more persuasive of two plausible but contradictory inferences. It is the jury which weighs the contradictory evidence and inferences and draws the ultimate conclusion as to the facts." 498 F.2d at 1198

With regard to the second contention that "this court may consider the matter *de novo* as it were," the Fourth Circuit noted that the legal conclusion of the bona fides of a sale and leaseback transaction is necessarily grounded in underlying findings of fact.

> "We are not persuaded that the ART-Helmsley transaction must necessarily be characterized as a sham, as less than *bona fide*, or as, 'in substance,' a secured loan. There was considerable evidence in the record to the effect that the intent of the parties, acting in complete good faith, was to undertake a sale to ART with a subsequent leaseback to Helmsley. There was testimony tending to show that Helmsley decided to exercise his option because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal with ART. Moreover, there was testimony that the agreed upon purchase price—$7,000,000—was 'fair,' and not an unduly low one as the government asserts. These factors appear to us to provide sufficient basis for the conclusion that the sale-and-leaseback was in substance a *bona fide* transaction. This is not to suggest of course that we believe that tax considerations played no part whatsoever in the planning of the deal. Merely because tax planning may have preceded a transaction, or because tax savings have flowed from it, we are not constrained to characterize the entire event as primarily, or even substantially, a tax avoidance device." 498 F.2d at 1199

This treatment of the specific issue of the bona fides of a sale-leaseback merely reflects the general standard of review under Rule 52(a) Fed.R.Civ.Pro. that the factual findings of the district court, even factual inference from undisputed facts, must not be overturned unless clearly erroneous. This Court has been consistent and emphatic on this point. *See Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960); *see also United States* v. *U.S. Gypsum Co.*, 333 U.S. 364, 394 (1948); *United States* v. *Singer Manufacturing Co.*, 374 U.S. 174, 194 n.9 (1963); 9 Wright & Miller, Federal Practice and Procedure §§ 2587; 2589 (1971). *See also, Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (9th Cir. 1974), *supra*, note 30. This rule applies to cases tried on documentary as well as oral evidence. See *Lundgren* v. *Freeman*, 307 F.2d 104, 113-115 (9th Cir. 1962); *Wright & Miller, supra*, § 2587.

As Judge Brown said in *Horton* v. *U.S. Steel Corp.*, 286 F.2d 710, 713 (5th Cir. 1961), the trial court's findings "come here well armed with the buckler and shield of F.R.Civ.P. 52(a) . . ." Nor should Rule 52(a) "be construed to encourage appeals that are based on the hope that the appellate court will second-guess the trial court."

The syllogism implicit in the holding below—substance is a matter of interpretation of documents, interpretation of documents is a legal matter, therefore,

CONCLUSION

Lyon's entitlement to the deductions for depreciation, interest, and interim expenses, is supported by the language of the statute, by considerations of tax policy, economic reality, and proper appellate review. The judgment of the court of appeals should be reversed and the district court's decision should be affirmed by this Court.

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substance of the transaction must be purely a legal determination—is blankly specious. An appellate court attempting *de novo* to reevaluate the "substance" of a transaction on appeal mistakes the proper bounds of appellate review, and, as here, is very likely to mistake the nature of the transaction under consideration as well.

Lyon's position is a simple one, which accords with the case law and normal appellate practice: appreciation of the "substance" of a transaction for tax purposes requires factual determinations about the intent and circumstances of the parties, and about the nature of the interests created by the transaction. On review, appellate courts must give appropriate deference to the factual findings on these matters by the court which tried the case.